



BUSINESS LICENSE UNIT OPERATIONS PERFORMANCE AUDIT

JUNE 2012



CITY OF DURHAM
AUDIT SERVICES DEPARTMENT

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assurance and investigative services”*

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To: Audit Services Oversight Committee
From: Germaine F. Brewington, Director
Audit Services Department
Date: June 23, 2012
Re: Transmittal of Business License Unit Operations
Performance Audit (**June 2012**)

The Department of Audit Services completed the report on the Business License Unit Operations Performance Audit dated June 2012. The purpose of the audit was to determine the extent to which controls and procedures are in place to support the accurate and effective billing and collection of City of Durham business license taxes.

This report presents the observations, results, and recommendations of the Business License Unit Operations Performance Audit. City management concurs fully with the recommendations made. Management's response to the recommendations is included with the attached report.

The Department of Audit Services appreciates the contribution of time and other resources from employees of the Department of Finance in the completion of this audit.

TABLE OF CONTENTS

<u>BACKGROUND INFORMATION</u>	5
<u>EXECUTIVE SUMMARY</u>	8
<u>OBJECTIVES, SCOPE AND METHODOLOGY</u>	10
<u>AUDIT RESULTS</u>	13
<u>RECOMMENDATIONS</u>	19
<u>MANAGEMENT’S RESPONSE</u>	23

BACKGROUND INFORMATION

Business owners doing business within the City of Durham limits are subject to the business privilege license requirements set forth in the City's Code of Ordinances. The North Carolina General Assembly through Schedule B of the Revenue Act and the City of Durham through its City Code have authorized this requirement. The City of Durham's License and Privilege Tax Ordinance, in accordance with North Carolina General Statutes, requires every business not specifically exempted to obtain a City of Durham privilege license, to pay the appropriate tax before engaging in any business activity within City limits. A business privilege license allows officials to know who is conducting business in the City, as well as the location and type of businesses in the City. The privilege license assists City officials in ensuring a business is located in an area that is properly zoned and ensures that the business has adequate access to basic City services.

Unless specifically exempt under North Carolina State law, a privilege license is required for anyone who:

- Maintains a business location within the City of Durham
- Solicits business within the City of Durham (personally or through agents)
- Picks up or delivers goods or services within the City of Durham.

A Durham business privilege license must be purchased annually and is issued for a one-year period that begins July 1 and ends June 30 of the following year. Each new business should purchase a license and have it in hand on the first day that they do business. A business must renew the privilege license no later than July 1 of each year.

There are two methods of determining a business privilege license tax liability:

Gross Annual Sales

Computation of the business privilege license tax for businesses classified as retail, wholesale, manufacturing, or service businesses are based on gross annual sales.



BACKGROUND INFORMATION

Flat Fee

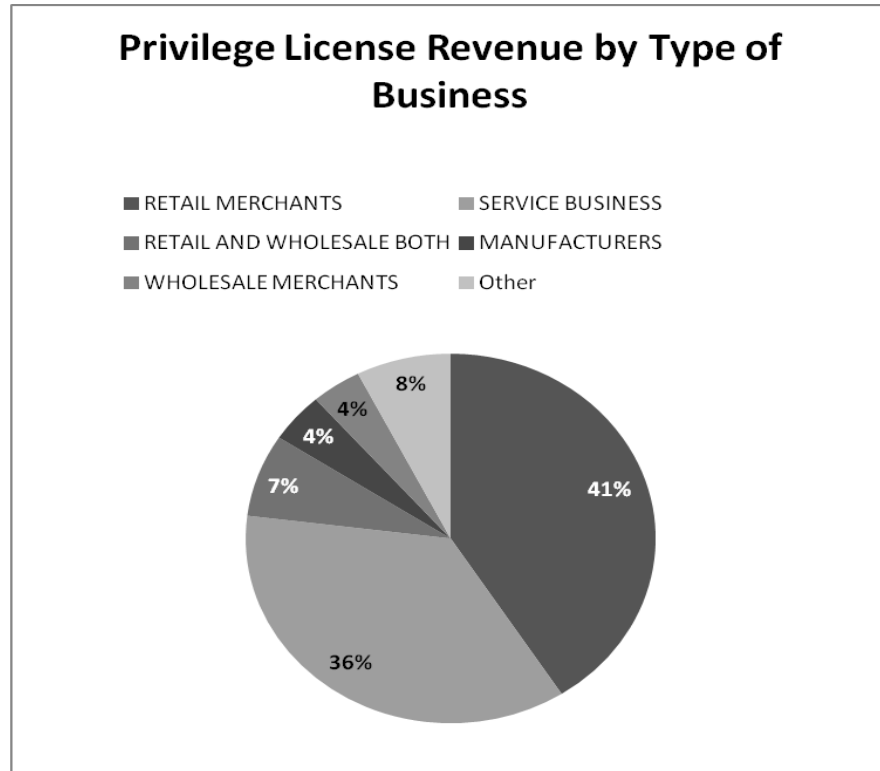
Other types of businesses are taxed according to a flat fee rate.

It is the responsibility of each individual to determine whether the business he or she conducts is taxed under the City ordinance, and if so, whether that tax has been paid for the current year. No person or business entity conducting business within the City limits of the City of Durham, for which a business license is required, shall do so without first obtaining a business privilege license and paying the appropriate fee(s). Any business conducting business activity within the City limits of Durham without a license, shall be liable for back (unpaid) business license taxes and subject to a penalty of 5 percent of the annual license tax for each month that the business operates without a license, up to a maximum of 25 percent per annum.

In May each year, the Finance Department sends a Business License Tax Renewal Application to all business license holders listed in the City's Data Base Management System (DBM). The business license system is designed for use by cities and counties to manage the issuance of business licenses and track historical detail about the business licenses. Taxpayers are instructed to fill in their gross receipts information, calculate the tax and return the form to the Finance Department with payment. The taxpayer can pay in person (cash, check or credit card) or can make a payment by check only via mail.

BACKGROUND INFORMATION

Graph 1 below shows privilege license revenue by type of business for fiscal year 2012.



Revenue reported in the general ledger from business license taxes was approximately \$3,134,374 for fiscal year 2011 and approximately \$2,655,008 for fiscal year 2012 to date.

EXECUTIVE SUMMARY

Purpose

The purpose of the audit is to determine the extent to which controls and procedures are in place to support the accurate and effective billing and collection of City of Durham business license taxes.

We conducted this performance audit in accordance with generally accepted governmental auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

The Business License Unit staff demonstrated a high level of customer service and professionalism. Management was forthcoming with information requested during the course of the audit.

Effective practices include:

- An overall adequate process over cash collections from walk-ins;
- An adequate reconciliation process between the DBM system and MUNIS ;
- An adequate reconciliation of deposits to the general ledger;
- Adequate supervision over daily tasks; and
- Effective monitoring of operations using reports from the DBM system.

EXECUTIVE SUMMARY

Practices/activities where improvement is needed:

- Strengthening the control environment by establishing written policies and procedures;
- Establishing a systematic process for identifying businesses that do not have a current business license; and
- Exploring the possibility of processing payments via a lockbox, to eliminate the risk of mishandling of checks due; and to realize other efficiencies in operations.

OBJECTIVES, SCOPE AND METHODOLOGY

Objectives

The objectives of the audit were to:

- Determine the adequacy of management policies and procedures pertaining to the business license function;
- Determine if adequate controls exist over cash collections;
- Determine if adequate controls exist over the application renewal process; and
- Determine whether the Business License Unit has adequate controls to collect business license taxes equitably and accurately from all individuals and entities conducting business in the City of Durham.

Scope

The Scope of the audit included all current practices as they relate to the functions and operations of the Business License Unit.

Methodology

In order to achieve the objectives of the engagement, audit staff performed the following steps and procedures:

1. Obtained and reviewed policies/procedures pertaining to the Business License Unit function;
2. Obtained and reviewed ordinances pertaining to privilege license tax;
3. Reviewed the execution of policies and procedures associated with unpaid business license taxes;
4. Reviewed and documented the process for a business to appeal the penalty assessment, interest charge or license tax for the prior year;
5. Reviewed the application of interest charges on unpaid balances;

OBJECTIVES, SCOPE AND METHODOLOGY

6. Tested a sample selection of business license taxes, penalty assessments and interest charges and postings in the DBM database by reconciling payments to the MUNIS system;
7. Selected a sample per the Schedule A Privilege License Tax listing and verified the calculation of payment amount based upon estimated/reported revenues;
8. Selected a sample per the Schedule B Privilege License Tax listing and verified the accuracy of the payments based on the application form and the stated type of business;
9. Performed a walkthrough of the operations;
10. Performed a surprise cash count;
11. Verified controls over cash collections including receiving, depositing, reconciling and segregation of duties;
12. Documented the application renewal process;
13. Determined the adequacy of the process in place to ensure all businesses that should have renewed their privilege license tax have renewed their licenses and made payments;
14. Verified documentation to determine if stated procedures are being followed;
15. Selected a sample of businesses that did not renew their licenses for the fiscal year 2012 and determined whether they are currently conducting business within the City of Durham;

OBJECTIVES, SCOPE AND METHODOLOGY

16. Documented the process to ensure collections of business license tax are equitable and accurate from all individuals and entities conducting business in the City of Durham;
17. Evaluated the extent (amount/percentage) to which the Business License Unit validates the accuracy of the income reported by businesses;
18. Selected a sample of recent business license tax payments to determine whether payments reflect the most current reported taxable income;
19. Compared public information records and other third party sources (Chamber of Commerce, Sonic Print) to the DBM database to determine if businesses that are listed in third party sources have acquired a business license from the City of Durham; and
20. Selected a sample of vendors that conduct business with the City of Durham and verified if they have acquired a business license.

During the audit, staff also maintained awareness to the potential existence of fraud.

AUDIT RESULTS

Activities that are being carried out effectively include:

- An adequate process over cash collections from businesses paying in person at the Business License Unit office;
- An adequate reconciliation process between the DBM system and MUNIS;
- An adequate reconciliation of deposits to the general ledger;
- Adequate supervision over daily tasks; and
- Effective monitoring of operations using reports from the DBM system.

Areas for improvement include:

Finding 1: Formal written standard operating procedures do not exist

Written standard operating procedures (SOP) help reduce the possibility of human error and provide guidelines for employees to follow. SOPs help create consistency over process performance and provide a method to communicate process changes to employees. The current standard operating procedure FOP 704.01, "Rules and Procedures for the Handling of City Cash" apply to collections of all city cash. There are no other policies/procedures pertaining to the operation of the Business License Unit. The Unit follows ordinances and North Carolina General Statutes that relate to business licenses. Written SOPs do not exist for the following areas:

- The application renewal process:
 - The process to contact customers that have not returned their Business License Renewal Forms;
 - Definitions of active, inactive, suspending, pending status and reason codes used in the DBM database;
 - The process to document responses received from customers who have been contacted; and

- Conditions warranting a manual status change in the DBM database.
- The management oversight process:
 - Standard operating procedures should be written and should describe the types of reports used by management as well as the frequency of review of these reports.

Finding 2: Controls over the application renewal process are not sufficient

Potential risk of fraud exists as all agents have the ability to make adjustments, change the status of a business in the DBM system and handle cash/checks.

At present, increased potential for loss to occur exists because all Business License Unit Agents have access to the following:

- All agents can make changes to the status of a business (active, inactive, pending). The status of the business determines whether the business needs to obtain a business license from the City. A business that has an inactive status (either out of business or does not conduct business within the City) does not owe the City any monies.
- All agents have the ability to make needed adjustments due to incorrect payment amounts entered, extra payments posted in error, incorrect gross receipts amounts entered, etc.
- All agents handle cash/checks. Adequate controls do not exist over checks that come in through the mail.

At present, proper management oversight controls exist to mitigate risk associated with all agents having the access and authority to make adjustments. The Manager and Supervisor review on a daily basis, all adjustments processed via an Adjustment Report. They verify documentation for unusual adjustments.

AUDIT RESULTS

Limited management oversight exists over the ability of all agents to change the status of a business in the DBM system. According to the Business License Unit Manager, an audit trail exists in the DBM system that tracks by agent, changes that are made to accounts. The review of audit logs however, occurs only when there is reason for suspicion. The current process requires agents to change the status of a business from suspended to inactive upon receipt of written notification from the business owner. Agents maintain this documentation in their offices. An adequate monitoring mechanism should be in place to ensure that appropriate documentation exists to support any manual status change.

In addition, adequate controls do not exist over processing of payments received via the mail system. The current procedure does not require that a log be maintained of all checks received through the mail. In addition, a reconciliation is not performed to ensure all checks received through the mail were actually deposited. The volume of checks received during the period of May to July however, limits the ability of the staff to perform this procedure. Checks can be lost or misappropriated without detection as a result of this lack of control. This lack of control in combination with the ability of the staff to make status changes to accounts can further increase the risk of loss to the City. According to the Business License Unit Manager, a business owner will call and inquire if they do not receive a business license when they have paid the fee. While it is acceptable to rely on this as a control to mitigate the risk, it is an after the fact or corrective control. Implementing additional internal procedures that are more preventative and detective will help further mitigate this risk.

Revise the renewal form to provide clarity

The current Business Tax Renewal Application contains the statement “If Out of Business – Indicate Date Closed”. For a business owner who is out of business, it is unclear whether they need to return the form since they do not need a business license. In addition, the application does not currently address businesses that are still operating but do not plan to conduct business within

the City limits. The Renewal Application for the City of Greensboro states, "If no longer operating a business in the City of Greensboro please complete this information and return". Another sample renewal form reviewed states, "If you do not plan to conduct business within the City in the coming year, complete and return". Revising the Renewal Application to clarify the information requested will improve the efficiency of the renewal process.

As stated earlier, management relies on businesses notifying the City if they do not receive a license as a means to detect fraud. The current application does not state this. The application should state that: 1) businesses must call if they do not receive a license from the City; or 2) a business license will be returned to you provided all taxes are current.

Finding 3: Existing efforts to collect business license taxes equitably and accurately from all individuals and entities conducting business in the City of Durham are not sufficient

Internally, a predefined formula is used to verify the accuracy of the business tax owed based on reported revenue for schedule A businesses.

The accuracy of business license taxes received in part is contingent on the gross receipts reported by the business owner. At present, the Business License Unit Manager performs variance analysis on revenue reported from one year to the next. According to the Manager, "additional information is requested on a sample basis to verify the accuracy of the gross receipts". According to Chapter 30, Article V- Privilege License Taxes of the City Code of Ordinances, Sec. 30-226 - Duty to Permit Inspection, "each person who conducts business in the City shall permit the tax collector to inspect his or her business premises during normal business hours to determine the nature of the business conducted there and to examine the business books and records to determine the nature and amount of business transacted". Documentation to support the examination of gross receipts from businesses did not exist.

AUDIT RESULTS

Equitable for audit purposes was defined as, “all businesses that are required to acquire a business license are in fact obtaining one”. One of the objectives for the Businesses License Unit per the fiscal year 2012 budget was, “to maximize earnings from business licensing by ensuring that discovery efforts result in at least a 5% increase in the number of licensed businesses”. The defined strategy was to increase diligence in identifying unlicensed businesses operating within the City and to develop an audit program to achieve this. At present the Manager utilizes several discovery mechanisms, however the approach is not structured. Some of these tools include:

- A report from MUNIS which lists all new non-residential customers for water/sewer services emailed monthly;
- A North Carolina Secretary of State monthly download of all new corporations registered for Durham County;
- A file of all newly registered businesses with the Register of Deeds exported from the County of Durham website; and
- The City of Durham’s Inspections Department’s listing of new commercial permits.

The Business License Unit uses multiple sources to identify open, viable businesses that have not paid their tax. However, a formal process does not exist for systematically identifying active businesses that do not have a current license.

Audit staff performed discovery efforts to determine if all businesses are obtaining a business license as required. Audit staff used business listings from third party sources such as the Chamber of Commerce and Sonic Print. The following steps were performed:

- The Chamber of Commerce data was not in an electronic file format, therefore a judgmental sample was selected;

AUDIT RESULTS

- Audit staff received data from Sonic Print in an electronic format. The data was matched to the data from the DBM system. Around 90 businesses were identified as having an exact match in both systems. Of these 90 businesses, 34 businesses appeared as inactive in the DBM system and were selected for further investigation;
- A judgmental sample was selected from the businesses in Sonic Print that did not match to the DBM system;
- Audit staff contacted the businesses in both the Chamber of Commerce and Sonic Print samples to inquire if they had an active business license or if they were still conducting business within City limits;
- Audit staff notified the Business License Unit Manager of these businesses and efforts were undertaken by the Manager to contact these businesses.

Table 1 displays the results of the discovery efforts undertaken by Audit staff:

Source	Sample Selected	Businesses that should have had a business license but did not
Chamber of Commerce	26	3
Sonic Print & DBM	34	2
Sonic Print Only	30	3
DBM - Businesses Have not Renewed	25	3
City of Durham Active Vendors List	25	4
Total	140	15

Approximately 10.7% (15 businesses out of the 140) of the selected business sample should have had a business license but did not.

RECOMMENDATIONS

Recommendation 1

The Business License Unit of the Finance Department should establish written standard operating procedures. The procedures should address at least the following areas:

- The application renewal process; and
- The management oversight process – types of reports and frequency of review.

Recommendation 2

Strengthen controls to collect business license taxes equitably and accurately from all individuals and entities conducting business in the City of Durham by performing the following:

- Establish a formal discovery process to maximize earnings from business licenses; and
- Verify accuracy of revenue reported on a sample basis for businesses that show unusual change in gross receipts based on the variance analysis performed; or
- Verify gross receipts for the first year of business.

Recommendation 3

The Business License Unit of the Finance Department should perform a cost benefit analysis of using a lockbox to process payments received via mail and determine if it is a viable option.

Recommendation 4

The Business License Unit of the Finance Department should increase monitoring oversight over status changes entered by agents (specifically inactive status changes). Management should review businesses that are classified as inactive over a given period and ensure that changes are supported by documentation.

RECOMMENDATIONS

Recommendation 5

The Business License Unit of the Finance Department should revise the Business Tax Renewal Application. The revision should:

- Address businesses that are currently operating but do not plan to conduct business within City limits;
- Clarify when the application should be completed and returned particularly as it relates to businesses which are out of business or do not plan to operate within the City limits; and
- State that the business license document will be returned provided all taxes are current.

MANAGEMENT'S RESPONSE



**CITY OF
DURHAM**

Memo to: Germaine F. Brewington, Director of Audit Services
From: David Boyd, Director of Finance
Date: June 13, 2012
Subject: Management's Response
Business License Unit Operations Performance
Audit (**June 2012**)

The following is the management's response to the Business License Unit Operations Performance Audit (June 2012).

Recommendation 1

The Business License Unit of the Finance Department should establish written standard operating procedures. The procedures should address at least the following areas:

- The application renewal process; and
- The management oversight process – types of reports and frequency of review.

Management's Response

We concur. Management is in full agreement with the recommendation.

General Billing and Collections Manager will create and establish written standard operating procedures to address the following areas:

- The application renewal process; and
- The management oversight process – detailing types of report and frequency for review.

The Department Director will provide a written response to the Audit Director. Implementation Date: November 2012.



MANAGEMENT'S RESPONSE

Recommendation 2

Strengthen controls to collect business license taxes equitably and accurately from all individuals and entities conducting business in the City of Durham by performing the following:

- Establish a formal discovery process to maximize earnings from business licenses; and
- Verify accuracy of revenue reported on a sample basis for businesses that show unusual change in gross receipts based on the variance analysis performed; or
- Verify gross receipts for the first year of business.

Management's Response

We concur. Management is in full agreement with the recommendation. Implementation Date: January 2013.

Recommendation 3

The Business License Unit of the Finance Department should perform a cost benefit analysis of using a lockbox to process payments received via mail and determine if it is a viable option.

Management's Response

We concur. Management is in full agreement with the recommendation. Implementation Date: November 2012.

Recommendation 4

The Business License Unit of the Finance Department should increase monitoring oversight over status changes entered by agents (specifically inactive status changes). Management should review businesses that are classified as inactive over a given period and ensure that changes are supported by documentation.

Management's Response

We concur. Management is in full agreement with the recommendation.

MANAGEMENT'S RESPONSE

The General Billing Collection Manager has informed all staff that before a license status is changed to inactive that on the comment screen of the Database Management System that a reason be placed on these accounts. Additionally GBC Manager will run a monthly report to verify a sampling of these accounts.

Implementation Date: June 2012.

Recommendation 5

The Business License Unit of the Finance Department should revise the Business Tax Renewal Application. The revision should:

- Address businesses that are currently operating but do not plan to conduct business within City limits;
- Clarify when the application should be completed and returned particularly as it relates to businesses which are out of business or do not plan to operate within the City limits; and
- State that the business license document will be returned provided all taxes are current.

Management's Response

We concur. Management is in full agreement with the recommendation.

General Billing and Collections Manager will revise business license documentation as recommended.

Implementation Date: June 2012.